



SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-96520; File No. SR-FINRA-2022-021]

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Partial Amendment No. 1 to Proposed Rule Change to Adopt Supplementary Material .18 (Remote Inspections Pilot Program) under FINRA Rule 3110 (Supervision)

December 16, 2022.

I. Introduction

On July 28, 2022, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act” or “Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change (SR-FINRA-2022-021) to amend FINRA Rule 3110 (Supervision) to adopt a voluntary, three-year remote inspection pilot program to allow member firms to elect to fulfill their obligation under Rule 3110(c) (Internal Inspections) by conducting inspections of some or all branch offices and locations remotely without an on-site visit to such office or location, subject to specified terms.

The proposed rule change was published for public comment in the Federal Register on August 15, 2022.³ On September 23, 2022, FINRA consented to an extension of the time period in which the Commission must approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change to November 11, 2022.⁴ On November 9, 2022, FINRA filed a letter stating that it was

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Exchange Act Release No. 95452 (August 9, 2022), 87 FR 50144 (August 15, 2022) (File No. SR-FINRA-2022-021) (“Notice”).

⁴ See letter from Sarah Kwak, Associate General Counsel, Office of General Counsel, FINRA, to Daniel Fisher, Branch Chief, Division of Trading and Markets, Commission, dated September 23, 2022.

considering comments received in response to the Notice, and anticipated submitting a response and amendments to the proposed rule change in the near future.⁵ On November 10, 2022, the Commission filed an order instituting proceedings to determine whether to approve or disapprove the proposed rule change.⁶ The Commission received several comments on the proposed rule change.⁷

On December 15, 2022, FINRA responded to the comment letters received on the Notice and OIP⁸ and filed a partial amendment to the proposed rule change in response to certain comments on the proposed rule change (“Partial Amendment No. 1”). Partial Amendment No. 1 is described in Item II below, which has been substantially prepared by FINRA.⁹ The Commission is publishing this notice to solicit comments on Partial Amendment No. 1 from interested persons.¹⁰

II. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Partial Amendment

FINRA is proposing the following amendments to the filing:

1. **FINRA proposes to amend proposed Rule 3110.18(b) by adding subpart (2)**

In light of concerns raised by commenters that a firm might not appropriately consider certain higher risk criteria in conducting its risk assessment, FINRA is proposing to add new

⁵ See letter from Sarah Kwak, Associate General Counsel, Office of General Counsel, FINRA, to Vanessa Countryman, Secretary, SEC, dated November 9, 2022.

⁶ See Exchange Act Release No. 96297 (November 10, 2022), 87 FR 68774 (November 16, 2022) (File No. SR-FINRA-2022-021) (“OIP”).

⁷ Comments received on the Notice and OIP are available on the Commission’s website at <https://www.sec.gov/comments/sr-finra-2022-021/srfinra2022021.htm>.

⁸ See letter from Kosha Dalal, Vice President and Associate General Counsel, Office of General Counsel, FINRA, to Vanessa Countryman, Secretary, Commission, dated December 15, 2022, available at <https://www.sec.gov/comments/sr-finra-2022-021/srfinra2022021-20152889-320539.pdf>.

⁹ The Commission has reformatted FINRA’s presentation of its proposed modifications to, and descriptions of, the proposed rule change.

¹⁰ Partial Amendment No. 1 is also available on FINRA’s website at <https://www.finra.org/sites/default/files/2022-12/sr-finra-2022-021-amendment-no-1-proposed-rule-change.pdf>.

paragraph (b)(2) to proposed Rule 3110.18 that would provide a non-exhaustive list of factors that a firm must consider and document. In addition, proposed new paragraph (b)(2) would further provide that consistent with Rule 3110.12, members should conduct on-site inspections or make more frequent use of unannounced, on-site inspections for high-risk locations or where there are “red flags.” Following are the changes proposed in this Partial Amendment No. 1, with the proposed changes in the original filing shown as if adopted. Proposed new language in this Partial Amendment No. 1 is italicized; proposed deletions in this Partial Amendment No. 1 are in brackets:

(2) In conducting the risk assessment of each office or location in accordance with Rule 3110.18(b)(1), a member shall consider, among other things, the following in making their risk-based evaluation of each office or location: (A) the volume and nature of customer complaints; (B) the volume and nature of outside business activities, particularly investment-related; (C) the volume and complexity of products offered; (D) the nature of the customer base, including vulnerable adult investors; (E) whether associated persons are subject to heightened supervision; (F) failures by associated persons to comply with the member’s written supervisory procedures; and (G) any recordkeeping violations. In addition, consistent with Rule 3110.12, members should conduct on-site inspections or make more frequent use of unannounced, on-site inspections for high-risk locations or where there are “red flags.”

FINRA expects a firm to carefully consider the proposed factors listed above and Rule 3110.12 for the risk assessment. The outcome of such assessment may raise red flags that should prompt a firm to consider, among other things, inspecting, remotely or on-site, its offices or locations more frequently than the schedule set forth under Rule 3110(c)(1) (on an announced or unannounced basis). Moreover, FINRA notes that Rule 3130 (Annual Certification of Compliance and Supervisory Processes) requires member firms to have processes to establish, maintain, review, test, and modify written compliance policies and written supervisory

procedures reasonably designed to achieve compliance with applicable FINRA rules, Municipal Securities Rulemaking Board rules, and federal securities laws and regulations. FINRA expects firms to consider Rule 3110.18 as part of their Rule 3130 annual certification process.

2. FINRA proposes to amend proposed Rule 3110.18(c) by adding subparts (1)(A)(iii)-(vi)

As proposed, the proposed rule change would exclude some member firms and their offices or locations from participating in the proposed pilot program based on events or activities of a member firm or its associated persons that FINRA believed were more likely to raise investor protection concerns based on the firm's or an associated person's record of specified regulatory or disciplinary events. In light of concerns raised by the commenters, FINRA is proposing to expand the list of events that would deem a member firm ineligible to participate in the pilot program. Following are the changes proposed in this Partial Amendment No. 1, with the proposed changes in the original filing shown as if adopted. Proposed new language in this Partial Amendment No. 1 is italicized; proposed deletions in this Partial Amendment No. 1 are in brackets:

(c) Eligibility Exclusions and Conditions

(1) Firm Level

[2](A) A member shall not be eligible to conduct remote inspections of any of its offices or locations in accordance with this Supplementary Material if any time during the period of this Remote Inspections Pilot Program, the member[is or becomes]:

(i) is or becomes designated as Restricted Firm under Rule 4111;

[or]

(ii) is or becomes designated as a Taping Firm under Rule 3170[.];

(iii) receives a notice from FINRA under Rule 9557 under Rule 4110 (Capital Compliance), Rule 4120 (Regulatory Notification and Business Curtailment) or Rule 4130 (Regulation of Activities

of Section 15C Members Experiencing Financial and/or Operational Difficulties), unless FINRA has otherwise permitted activities in writing pursuant to such rule;

(iv) is or becomes suspended by FINRA;

(v) based on the date in the Central Registration Depository (CRD), had its FINRA membership become effective within the prior 12 months; or

(vi) is or has been found within the past three years by the SEC or FINRA to have violated Rule 3110(c) (Internal Inspections).

FINRA believes that a member firm that is experiencing issues complying with its capital requirements or has been suspended by FINRA is more likely to face significant operational challenges that may negatively impact the firm's inspection program. FINRA further believes that a firm that has been a FINRA member for less than 12 months is often still implementing its business plan and may not have sufficient experience to develop a sufficiently robust inspection program. With respect to a firm that is or has been found within the past three years by the SEC or FINRA to have violated Rule 3110(c), FINRA believes such firms have demonstrated challenges in developing or maintaining robust inspection programs. As such, FINRA believes that these proposed additional ineligibility criteria would appropriately limit the potential population of member firm pilot program participants to those firms that may be better positioned to conduct remote inspections. Moreover, FINRA believes these amendments more appropriately tailor the proposal to maintain investor protection.

3. FINRA proposes to amend proposed Rule 3110.18(c) by adding subpart (1)(B)

To further address commenters' concerns pertaining to the proposed controls of the pilot program, FINRA is proposing to enhance those controls with respect to books and records and surveillance and technology tools. Following are the changes proposed in this Partial Amendment No. 1, with the proposed changes in the original filing shown as if adopted.

Proposed new language in this Partial Amendment No. 1 is italicized; proposed deletions in this Partial Amendment No. 1 are in brackets:

(c) Eligibility Exclusions and Conditions

(1) Firm Level

(B) In addition to the requirements of this Supplementary Material, during the period that a member is participating in this Remote Inspections Pilot Program the member must satisfy the following conditions to be eligible to conduct remote inspections of any of its offices or locations in accordance with this Supplementary Material:

(i)(a) the member must have a recordkeeping system to make and keep current, and preserve records required to be made and kept current, and preserved under applicable securities laws and regulations, FINRA rules, and the member's own written supervisory procedures under Rule 3110; (b) such records are not physically or electronically maintained and preserved at the office or location subject to the remote inspection; and (c) the member has prompt access to such records; and

(ii) as part of the requirement to develop a reasonable risk-based approach to using remote inspections, and the further requirement to conduct and document a risk assessment for each office or location, the member must determine that its surveillance and technology tools are appropriate to supervise the types of risks presented by each such office or location. These tools may include but are not limited to: (a) firm-wide tools such as, electronic recordkeeping system; electronic surveillance of e-mail and

correspondence; electronic trade blotters; regular activity-based sampling reviews; and tools for visual inspections; (b) tools specific to that office or location based on the activities of associated persons, products offered, restrictions on the activity of the office or location (including holding out to customers and handling of customer funds or securities); and (c) system tools such as secure network connections and effective cybersecurity protocols.

FINRA believes these proposed new eligibility conditions are appropriate to establish reasonable baseline requirements for remote inspections.

4. **FINRA proposes to amend proposed Rule 3110.18(c) by adding subparts (2)(A)(v)-(vii)**

In light of the comment letters expressing concern about the discretion provided to firms to make risk assessments of the criteria specified earlier of their offices or locations, FINRA is proposing to expand the list of events or activities that would make specific offices or locations of a member firm ineligible for remote inspections. Following are the changes proposed in this Partial Amendment No. 1, with the proposed changes in the original filing shown as if adopted. Proposed new language in this Partial Amendment No. 1 is italicized; proposed deletions in this Partial Amendment No. 1 are in brackets:

(c) Eligibility Exclusions and Conditions

(1) Firm Level

[(B)](2) Location Level

(A) A specific office or location of a member shall not be eligible for a remote inspection in accordance with this Supplementary Material if any time during the period of this Remote Inspections Pilot Program[, an associated person at such office or location is or becomes]:

(i) one or more associated persons at such office or location is or becomes subject to a mandatory heightened supervisory plan under the rules of the SEC, FINRA or a state regulatory agency;

(ii) one or more associated persons at such office or location is or becomes statutorily disqualified, unless such disqualified person has been approved (or is otherwise permitted pursuant to FINRA rules and the federal securities laws) to associate with a member and is not subject to a mandatory heightened supervisory plan under paragraph [(b)(2)(B)(i)](c)(2)(A)(i) of this Supplementary Material or otherwise as a condition to approval or permission for such association;

(iii) the firm is or becomes subject to Rule 1017(a)(7) as a result of one or more associated persons at such office or location; or

(iv) one or more associated persons at such office or location has an event in the prior three years that required a "yes" response to any item in Questions 14A(1)(a) and 2(a), 14B(1)(a) and 2(a), 14C, 14D and 14E on Form U4[.];

(v) one or more associated persons at such office or location is or becomes subject to a disciplinary action taken by the member that is or was reportable under Rule 4530(a)(2);

(vi) one or more associated persons at such office or location is a part of the member's trading desk (e.g., engaging in market making activities or having authority to enter proprietary trades on behalf of the member or as agent for other parties; or

(vii) the office or location handles customers' funds or securities.

FINRA believes the expanded list of exclusions for specific offices or locations of a member further strengthens the terms of the proposed pilot program by identifying additional offices or locations that may particularly benefit from in-person inspections and expressly excluding them, regardless of any individual firm's risk assessment.

5. **FINRA proposes to amend proposed Rule 3110.18(c) by adding subparts (2)(B)(i)-(iii)**

To further address commenters' concerns regarding the proposed pilot program's controls, FINRA is proposing to add three new eligibility conditions to conduct a remote inspection during the pilot period. Following are the changes proposed in this Partial Amendment No. 1, with the proposed changes in the original filing shown as if adopted. Proposed new language in this Partial Amendment No. 1 is italicized; proposed deletions in this Partial Amendment No. 1 are in brackets:

(c) Eligibility Exclusions and Conditions

(1) Firm Level

[(B)](2) Location Level

(B) In addition to the requirements of this Supplementary Material, during the period a member is participating in this Remote Inspections Pilot Program a specific office or location of the member must satisfy the following conditions to be eligible for a remote inspection in accordance with this Supplementary Material:

(i) electronic communications (e.g., e-mail) are made through the member's electronic system;

(ii) the associated person's correspondence and communications with the public are subject to the firm's supervision in accordance with Rule 3110; and

(iii) no books or records of the member required to be made and kept current, and preserved under applicable securities laws and regulations, FINRA rules, and the member's own written supervisory procedures under Rule 3110 are physically or electronically maintained and preserved at such office or location.

6. **FINRA proposes to amend proposed Rule 3110.18 by adding subparts (k)**

FINRA is also proposing to adopt new paragraph (k) to proposed Rule 3110.18 to allow FINRA to make a determination in the public interest and for the protection of investors that a member is no longer eligible to participate in the proposed pilot program if the member fails to comply with the requirements of Rule 3110.18. If warranted, FINRA would provide written notice to the member of such determination and such member would no longer be eligible to participate in the proposed pilot program and would be required to conduct on-site inspections of required offices and locations in accordance with Rule 3110(c). Following are the changes proposed in this Partial Amendment No. 1, with the proposed changes in the original filing shown as if adopted. Proposed new language in this Partial Amendment No. 1 is italicized; proposed deletions in this Partial Amendment No. 1 are in brackets:

(k) Determination of Ineligibility. FINRA may make a determination in the public interest and for the protection of investors that a member is no longer eligible to participate in the Pilot Program if the member fails to comply with the requirements of Rule 3110.18. In such instances, FINRA will provide written notice to the member of such determination and the member would no longer be eligible to participate in the Pilot Program and must conduct on-site inspections of required offices and locations in accordance with Rule 3110(c).

FINRA believes this added authority would both align with FINRA's examination and risk monitoring programs for member firms and registered persons and allow FINRA to more effectively assess higher risk.

7. FINRA proposes to amend proposed Rule 3110.18 to make other non-substantive, technical changes to the proposed rule change

FINRA is also proposing to make other non-substantive, technical changes to the proposed rule change, including conforming changes to the numbering of the proposed rules and updating cross-references.

III. Date of Effectiveness of the Proposed Rule Change As Modified By Partial Amendment No. 1 and Timing for Commission Action

Within 45 days of the date of publication of the initial Notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will by order approve or disapprove such proposed rule change, as amended by Partial Amendment No. 1.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as amended by Partial Amendment No. 1, is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2022-021 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2022-021. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies

of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly.

All submissions should refer to File Number SR-FINRA-2022-021 and should be submitted on or before **[INSERT DATE 21 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹¹

Sherry R. Haywood,

Assistant Secretary.

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¹¹ 17 CFR 200.30-3(a)(12).